

“Fixing” Executive Compensation: Will Congress, Shareholder Activism, or the New SEC Disclosure Rules Change the Way Business is Done in American Boardrooms?

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A pervasive topic in current academic debate relating to corporate governance is the question of whether American executives “make too much.” Popular American sentiment seems to answer that question in the affirmative. Many have proposed significant changes to the system of executive compensation and some alterations have taken hold. Only the future will tell the effect of these developments. This Note focuses on the efforts of Congress and activist shareholders, and gives particular attention to the SEC’s new executive compensation disclosure rules. The new rules represent the most comprehensive change in over a decade to the way corporations must disclose executive compensation. This Note will evaluate the implementation of these new rules along with the other developments and analyze their likely effectiveness. Finally, the Note concludes by suggesting ways in which the SEC can adjust its rules to achieve its desired result and avoid creating unnecessary costs.

I. INTRODUCTION

In recent months, the pages of business journals, hours of legislative hearings, and academic discourse have been filled with discussions of “runaway” executive compensation in the boardrooms of the United States’ largest corporations.¹ While for most Americans, the inner workings of corporate boards are an opaque and uninteresting morass, the topic of overpaid executives can easily raise eyebrows and especially populist ire.² Research indicates that the growth of executive compensation as a media

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¹ See, e.g., *Empowering Shareholders on Executive Compensation: H.R. 1257, The Shareholder Vote on Executive Compensation Act: Hearing Before the H. Comm. on Financial Services*, 110th Cong. (2007); Shawn Tully et al., *Wall Street’s Money Machine Breaks Down*, *FORTUNE*, Nov. 26, 2007, at 64.

² One of the biggest critics of executive pay has been organized labor. The AFL-CIO has an entertaining webpage that keeps track of “exorbitant” executive compensation. The homepage shows a cartoonish illustration of a “fat cat” CEO foreclosing on a Monopoly house and carting away bags of money, all while a family, baby in arms, watches powerlessly from the side. Users can search compensation by company, read “case studies” illustrating egregious examples of executive pay, and fight back by urging congressional action in the field. AFL-CIO, 2008 Executive Paywatch, <http://www.aflcio.org/corporatewatch/paywatch/> (last visited Feb. 12, 2009).

topic has been, statistically, nothing short of extraordinary and that the tendency towards sensationalism appears to be strategically aimed at this populist mentality.³ The din has become increasingly prevalent following the Enron accounting scandal.⁴ Yet despite increased media attention in recent years, the tendency to characterize executives as “overpaid” is nothing new.⁵ The debate has been nearly continuous since President Franklin Roosevelt first railed against corporate greed in the 1940s.⁶

Most Americans likely do not understand the process by which boards award executive pay packages, yet the vast majority of Americans believe executives make too much,⁷ leading many to conclude that something must be done. Interestingly, the sentiment persists, even though executive pay has risen at a slower pace than that of many celebrities and professional athletes, who have been more or less immune from widespread vilification based on their compensation.⁸ To bolster their claims, advocates for reining in an era

³ John E. Core, Wayne Guay & David F. Larcker, *The Power of the Pen and Executive Compensation* 2, 14, 16 (May 23, 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=838347>) (finding that the increase in compensation related articles from 1994 to 2002 was approximately 900% and that the percentage of those articles with a “negative tone” was 36% and 47% amongst major newspapers and magazines, respectively).

⁴ LUCIAN ARYE BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* ix (2004) (“A wave of corporate scandals that began in late 2001 shook confidence in the performance of public company boards and drew attention to potential flaws in their executive compensation practices. There is now recognition that many boards have employed compensation arrangements that do not serve shareholders’ interests. But there is still substantial disagreement about the scope and source of such problems and . . . about how to address them.”).

⁵ George T. Milkovich and Bonnie R. Rabin, *Executive Compensation and Firm Performance: Research Questions and Answers*, in FRED K. FOULKES, *EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1900S* 81–83 (Harvard Business School Press 1991).

⁶ *Id.* at 81.

⁷ Harris Interactive, *Poll Finds Strong Populist Mood in Europe and to a Lesser Extent in the USA*, HARRIS POLL, tbl. 4, July 25, 2007, http://www.harrisinteractive.com/harris_poll/index.asp?PID=791 (indicating that 77% of Americans believe that executives are paid too much).

⁸ Perhaps those that entertain get a pass: *panem et circenses*. See Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 6 (2000) (“[W]hile CEO pay has risen much faster than the pay of average workers, CEO pay has risen much slower than the pay of professional athletes. During the period 1980–95, the pay of the average worker increased 60%, that of CEOs 380%, National Basketball Association players 640%, National Football League players 800%, and Major League Baseball players 1000%.”) (citing Jay W. Lorsch, *Compensating Corporate CEO's: A Process View*, fig.II (Harvard Bus. Sch. Working Paper No. 99-013, 1998)).

of overly exuberant compensation point to notable examples of “pay without performance.”⁹

The forced departure of former CEO Stanley O’Neal¹⁰ from an underperforming Merrill Lynch¹¹ provided much grist to this discussion.¹² Following Merrill’s asset write-down of some \$8 billion, Mr. O’Neal did get a pink slip but did not leave the company without first receiving his \$160 million cash severance package.¹³ O’Neal’s so-called “golden parachute”¹⁴

⁹ The phrase “pay without performance” has become intrinsically linked to Harvard Professor Lucian Arye Bebchuk whose recent scholarship has focused on the disconnect between corporate performance, *vis-à-vis* shareholder value creation, and executive compensation, particularly that of the CEO. His work is the best articulated and most widely followed scholarship arguing that executive compensation is broken and needs to be fixed with greater shareholder participation in compensation decisions. *See generally* BEBCHUK & FRIED, *supra* note 4. For a contrary view, arguing that executive compensation is essentially “just right” see Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.–Apr., at 125, 131. Professor Henderson has even argued that executives are *underpaid*. Audio Recording: Todd Henderson, *CEOs are Underpaid*, University of Chicago Law School (May 25, 2007), http://webcast-law.uchicago.edu/2007/spring/Henderson_CBI.mp3 (arguing that given current economic data and research, executives actually make too little, and further, contrary to Bebchuk’s agency costs argument, the empowerment of shareholders would have a negligible impact on both the practices determinant of the overall level of executive compensation).

¹⁰ For a brief history of Stanley O’Neal’s tenure at and impact on Merrill, see Randall Smith, *CEO Transforms Merrill, but Shift Comes at a Cost*, WALL ST. J., Oct. 8, 2007, at A1. The article demonstrates the irony of Mr. O’Neal’s fast fall from favor, having been at one time the darling of investors for taking the very risks that caused him to lose his job. *Id.* at A15.

¹¹ *See* Steve Rosenbush, *Merrill Lynch’s O’Neal Takes the Hit*, BUS. WK. ONLINE, Oct. 24, 2007, http://www.businessweek.com/bwdaily/dnflash/content/oct2007/db20071024_830456.htm?chan=top+news_top+news+index_top+story (“After factoring in the losses [the write-downs], revenues for the quarter fell an astonishing 94% to \$577 million.”).

¹² *See generally* Landon Thomas Jr. & Jenny Anderson, *A Risk-Taker’s Reign at Merrill Ends with a Swift, Messy Fall*, N.Y. TIMES, Oct. 29, 2007, at A1 (detailing the rise and fall of O’Neal at Merrill as well as the process by which the board of directors determined that Merrill needed new leadership).

¹³ Joann S. Lublin & Mark Maremont, *O’Neal’s Last Big Deal as Chief Executive: Determining the Terms of His Exit Package*, WALL ST. J., Oct. 30, 2007, at C1. In the aftermath of 2007’s sub-prime mortgage collapse, Merrill Lynch and many other large banks had to readjust (mark to market) the value of the assets they held that were affected by sub-prime mortgages. This resulted in the asset “write-down.” *Id.*

¹⁴ Golden parachutes or “golden goodbyes” are standard terms in CEO contracts, especially among large, publicly traded companies. They offer large payments in case of change of control or may also operate as a severance package for early termination of an employment contract, as in O’Neal’s case. BLACK’S LAW DICTIONARY 713 (8th ed. 2004). For a more detailed discussion of golden parachutes, see Richard P. Bress, *Golden*

mostly consisted of the accelerated vesting of O'Neal's company stock options.¹⁵ Other prominent examples include Charles Prince of Citigroup,¹⁶ Robert Nardelli of Home Depot,¹⁷ and Angelo R. Mozilo, executive chairman of Countrywide Financial.¹⁸ Countrywide was at the epicenter of 2007's sub-prime mortgage collapse,¹⁹ and shareholders felt the effects as Countrywide's stock price fell 79% from the beginning to the end of 2007.²⁰ Mr. Mozilo, however, was expected to receive in excess of \$100 million from the sale of his company to Bank of America.²¹

These examples illustrate the ease with which one can find egregious, negative examples of executives whose pay seems to be out of line with company performance.²² However, this Note will not attempt to answer whether executives make too much. It is sufficient to note the intense public and academic debate over the appropriate level of executive compensation,

Parachutes: Untangling the Ripcords, 39 STAN. L. REV. 955, 957 (1987). See also MARTIN LIPTON & ERICA H. STEINBERGER, 1 TAKEOVERS & FREEZEOUTS § 6.02, at 6–11 (2007).

¹⁵ Lublin & Maremont, *supra* note 13, at C1.

¹⁶ Robin Sidel, Monica Langley & Gregory Zuckerman, *Citigroup CEO Plans to Resign As Losses Grow*, WALL ST. J., Nov. 3, 2007, at A4 (reporting over \$8 billion in write-downs at Citigroup and Prince leaving with \$31 million).

¹⁷ Joann S. Lublin, Ann Zimmerman & Chad Terhune, *Moving Out: Behind Nardelli's Abrupt Exit*, WALL ST. J., Jan. 4, 2007, at A1 (leaving Home Depot with a languishing stock price and \$210 million).

¹⁸ Frank Ahrens, *Big Payday Awaits Chairman After Countrywide Sale*, WASH. POST, Jan. 12, 2008, at D1.

¹⁹ Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 730 (2006). At the time, Countrywide was among the largest mortgage companies in the United States and engaged in some of the most aggressive lending tactics. *Id.* Troubles with this type of lending strategy led to performance collapses and subsequent shareholder class action suits alleging misleading financial statements which painted a rosy corporate picture while impending disaster lurked not far behind. See, e.g., *Pappas v. Countrywide Financial Corp.*, No. 07-CV-05295, slip op. (C.D. Cal. 2007) (alleging securities law violations through material misrepresentations of financial disclosures and company projections).

²⁰ Ahrens, *supra* note 18, at D2.

²¹ *Id.* at D1.

²² For cynics, one of the most amusing examples of CEO excess is found in former Tyco chief Dennis Kozlowski, who now sits in a prison in upstate New York. At the trial, much was made of Kozlowski's purchases—more frequently with company funds—including “[a] \$15,000 poodle-shaped umbrella stand, a \$6,000 shower curtain for the maid's bathroom, a \$2 million birthday [party for his wife] in Sardinia replete with loin-cloth clad Roman ‘slaves,’ and an ice-sculpture of Michelangelo's David urinating liquor . . .” M. Todd Henderson and James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, 1837 (2005).

which is unlikely to be resolved in the near future.²³ Instead, this Note will focus on several discrete developments that have the potential to affect the way corporations currently deal with executive compensation. This Note will focus on three such developments: congressional action, private action, and regulatory action.

Part II focuses on the possibility of political action to affect executive compensation. Part II.A. will examine recent proposals by Congress to increase shareholder power over compensation decisions, through so-called “say on pay” legislation, while Part II.B. notes recent non-legislative, congressional efforts to raise public awareness of executive compensation issues.

Part III concerns recent private actions to influence executive pay. Part III.A. discusses the meteoric rise of institutional investors and activist hedge funds as powerful players in influencing corporate decisions over pay. For institutional investors, this follows largely from the creation of third-party standards for executive compensation by shareholder proxy services. The increasing reliance on proxy advisors by institutional investors forces corporations to heed these private regulatory standards. A less powerful, but increasingly successful phenomenon of shareholder movements is the subject of Part III.B. Through shareholder proposals, some corporate boards are taking seriously the demands of shareholder advocate groups to make compensation “more reasonable.”

Part IV analyzes the new rules on executive compensation implemented by the SEC in 2006 for the 2007 proxy season. This discussion is most critical, because, having been actually implemented, the regulations have already begun to affect the way in which corporations must deal with the disclosure of executive compensation and the decision as to what level and what kind of executive compensation is appropriate. Parts IV.A. and IV.B. will discuss, respectively, the contextual history as well the most significant changes the new rules have implemented. The subsequent Parts examine the changes wrought in the first round of disclosures under the new rules, including the SEC’s own assessment of compliance, and evaluate the likely effect the new rules will have on corporate compensation practices.

Finally, Part V consists of an evaluation of the relative effectiveness of each of these developments in the executive compensation landscape, with the conclusion that the SEC regulations are the most legitimate and effective tools to ensure that compensation is not excessive, at least in terms of what is palatable to shareholders and the market. This Note concludes with suggestions of ways in which the SEC might refine the rules to ensure the

²³ For those critical of current compensation practices, see, e.g., Lucian Arye Bebchuk, Jesse M. Fried, & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

purpose of disclosure is accomplished without incurring costs greatly in excess of benefits.

II. LEGISLATIVE ACTION

As noted above, the incendiary nature of executive compensation makes it a propitious target for populism.²⁴ It should, therefore, come as no surprise that Congress frequently makes attempts, whether whole-heartedly or not, to “do something” about runaway compensation for CEOs. Legislative actions have taken two forms: bills²⁵ and hearings.²⁶ Attempts to pass bills are efforts by Congress to explicitly regulate a corporation’s activity,²⁷ while hearings are intended to bring public light to the situation in the hope that public scrutiny will force companies to change.²⁸

A. Attempts by Congress to Regulate

Few explicit efforts to change executive compensation have been successful; however, representatives and senators continue to propose legislation.²⁹ The persistence of members of Congress to spend time considering legislation that has little hope of passing raises questions about the conviction of those members—is it an earnest effort or an attempt to pander to a captive audience?³⁰

Historically, the only successful executive compensation legislation, in terms of enactment, has taken the form of changes to the Internal Revenue Code. The most notable recent example was the 1993 amendment to the

²⁴ R. Glenn Hubbard, *Pay Without Performance: A Market Equilibrium Critique*, 30 J. CORP. L. 717, 717 (2005) (“I am worried that research in corporate finance, and to some extent law and economics, may have too big an impact on the popular outrage, and in fact, may be feeding this populism.”).

²⁵ See discussion *infra* Part II.A.

²⁶ See discussion *infra* Part II.B.

²⁷ See, e.g., H.R. 1257, 109th Cong. (2007) (outlining a proposal to require corporations to give shareholders an advisory vote on pay).

²⁸ See, e.g., Press Release, H. Comm. on Oversight and Gov’t Reform, Committee Holds Hearing on CEO Pay and the Mortgage Crisis (Mar. 7, 2008), available at <http://oversight.house.gov/story.asp?ID=1762>.

²⁹ See, e.g., discussion *infra*, note 30.

³⁰ See Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207, 219–21 (2008) (suggesting that legislative responses could be mere attempts to gain favor among constituents inflamed by the issue). “[P]oliticians want to signal to their constituents that they are working to advance their welfare” *Id.* at 219.

Code in which Congress limited deductibility of executive salary to one million dollars; however, the effectiveness of this measure is doubtful.³¹ Notwithstanding heretofore fruitless legislative efforts, some members of Congress have made taking a tough stance against high executive pay a trademark issue.³² In the end, the ingenuity of accountants and lawyers will always be able to find creative solutions to congressional attempts to limit executive compensation, particularly via the tax code. In contrast to legal scholarship, research from the business and economics academy indicates that executive pay is the result of a competitive market.³³ Taken at face value, this research strongly suggests that manipulations of the tax code, effectively government caps on pay, will cause market distortions. If the law attempts to dictate compensation at a level below market compensation, the overwhelming power of the market will find a way around this problem. A cap on salary would possibly lead to more equity-based schemes which would be subject to capital gains treatment rather than income tax treatment, decreasing tax revenues. Equity-based schemes undoubtedly encourage

³¹ 26 U.S.C. § 162(m)(1) (2000) ("In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration . . . exceeds \$1,000,000."). Most commentators have noted that § 162(m) is a classic example of the law of unintended consequences, because the amendments, designed to reduce compensation, have actually resulted in higher pay packages as a result of bonuses and stock options. Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1687 (2004) (describing the eventual rise in overall executive compensation following the § 162(m) attempts to cap executive pay). See also Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 926 (2007) ("The empirical evidence suggests that § 162(m) has had unintended consequences. Executive compensation has increased, while a large number of firms are apparently forfeiting valuable tax deductions. Both of these results are contrary to the intent of Congress.") Scholars explained that § 162(m) failed because, rather than being based on sound tax policy, it was the result of political pressure. *Id.* at 880, 884. See also Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code* 41–50, 52 (Villanova University School of Law, Public Law and Legal Theory Working Paper No. 2009-07), available at <http://ssrn.com/abstract=1372746> (efforts to adjust executive compensation through the tax code results in "ordinary" Americans bearing most of the burden).

³² Former Representative Martin Sabo of Minnesota provides a notorious example. His proposal to limit deductibility of corporate salary to some multiple of the lowest paid worker in the corporation has never received serious consideration but has been reintroduced some dozen times since the 1993 amendments. See SAM PIZZIGATI ET AL., INSTITUTE FOR POLICY STUDIES AND THE CENTER FOR CORPORATE POLICY, CONGRESS AND EXCESSIVE CEO PAY 2 (2007), http://www.corporatepolicy.org/pdf/congress_excessive_ceo_pay-030707.pdf.

³³ See, e.g., Loewenstein, *supra* note 8, and audio recording, *supra* note 9.

executives to focus more heavily on short-term stock performance, which is often criticized by the same individuals who wish to regulate executive pay. If the regulations applied only to public companies, which would seemingly be the target, then the incentives to remain private would be enormous. Further, executives confronted with tighter tax regulations would face strong incentives to use complex, offshore tax devices to shield taxation, potentially defeating much of the regulations' desired effect. Many hedge funds already employ these types of strategies.³⁴

Despite the failures of past legislation, some in Congress believe that they have the answer to corporate excesses—shareholder power. Representative Barney Frank and others have proposed, and the House has passed, the Shareholder Vote on Executive Compensation Act.³⁵ The Act would give shareholders a nonbinding advisory vote to approve executive compensation in conjunction with a company's proxy statement.³⁶ As with many so-called “say on pay” or outright salary restrictions, it is likely that this measure will be forgotten once the furor over executive pay subsides. Since it is unlikely that the bill will ever receive real consideration in the Senate, one might easily dismiss the measure as an attempt to earn political points with a “populist” measure. The real rub behind the story is the fact that the bill passed overwhelmingly in the House, and then-Senator Barack Obama had suggested at the time that he would plan to sponsor the bill in the Senate.³⁷ Perhaps in an attempt to catch a political wave, Senator Obama *did* sponsor such a bill.³⁸ These developments provided insight into how much congressional “meddling” voters were willing to tolerate on this issue.

Following the financial crisis of 2008–2009, Americans were especially sensitive³⁹ to executive compensation and the media obliged. In early 2009,

³⁴ See Summer Lepree, *Taxation of United States Tax-Exempt Entities' Offshore Hedge Fund Investments: Application of the Section 514 Debt-Financed Rules to Leveraged Hedge Funds and Derivatives and the Case for Equalization*, 61 TAX LAW. 807, 807 (2008).

³⁵ H.R. 1257, 109th Cong. (1st Sess. 2007).

³⁶ As a precatory measure, the bill would not go far towards shareholder empowerment. Rather, the better term would be shareholder influence, via the *vox populi*. See *id.* A proxy statement is an SEC filing distributed to shareholders in advance of a shareholder annual meeting providing, among other items, details of executive compensation and information about the annual shareholder meeting. See Schedule 14A, Item 8, 17 C.F.R. § 240.14a-101 (2008).

³⁷ Kara Scannell & Siobhan Hughes, *House Clears an Executive-Pay Measure*, WALL ST. J., Apr. 21–22, 2007, at A3.

³⁸ S. 1181, 110th Cong. (2007).

³⁹ As President Obama put it, “[W]hat gets people upset—and rightfully so—are executives being rewarded for failure.” Remarks by President Obama on Executive Pay,

for example, Americans could hardly avoid becoming intimately acquainted with the decorating habits of Merrill Lynch Chief Executive, John Thain, whose expensive office redecoration was broadcast pervasively.⁴⁰ Absent the crisis, it is doubtful the same information would be newsworthy. In response to public disdain and perhaps seeing the opportunity to partially enact long-hoped-for compensation legislation, President Obama's "stimulus" bill⁴¹ amended the Emergency Economic Stabilization Act of 2008 (EESA)⁴² to regulate executive compensation for financial institutions who received "bailout" money under the EESA's Troubled Asset Relief Program (TARP).⁴³

The amendments greatly empower the Treasury to set "appropriate" limits on compensation in a variety of ways by limiting luxury expenditures,⁴⁴ prohibiting golden parachute payments,⁴⁵ providing enhanced clawback provisions,⁴⁶ prohibiting compensation plans that would induce "excessive" risk-taking,⁴⁷ etc. However, the most onerous provision disallows any "bonus, retention award, or incentive compensation"⁴⁸ for senior executives and highly compensated employees until government TARP money is repaid.⁴⁹ Although the legislation does allow for long-term compensation awards through restricted stock,⁵⁰ those awards are limited⁵¹

Feb. 4, 2009, available at <http://www.nytimes.com/2009/02/04/us/politics/04text-obama.html?ref=politics>.

⁴⁰ When Thain joined Merrill in December 2007, he spent nearly \$1.2 million redecorating his office. Although these expenditures occurred long before any bank bailouts were even considered, when the facts came to light, the public was digesting billions of dollars spent rescuing troubled banks, including Merrill Lynch's acquirer, Bank of America. *Merrill Lynch CEO Thain Spent \$1.22 Million on Office*, cnbc.com, Jan. 22, 2009, <http://www.cnbc.com/id/28793892/site/14081545>. At least Thain had good taste—Michelle Obama used the same designer for the White House redo. *Id.*

⁴¹ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

⁴² Pub. L. No. 100-343, 122 Stat. 3765 (2008).

⁴³ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 517–21 (2009).

⁴⁴ EESA, Pub. L. No. 100-343 § 111(d) (as amended Feb. 17, 2009).

⁴⁵ *Id.* at § 111(b)(3)(C) (as amended Feb. 17, 2009).

⁴⁶ The clawback allows for recovery of payments made to executives when it is later found that those payments were based on materially inaccurate financial information. *Id.* at § 111(b)(2)(B) (as amended Feb. 17, 2009).

⁴⁷ *Id.* at § 111(b)(3)(A) (as amended Feb. 17, 2009).

⁴⁸ *Id.* at § 111(b)(3)(D)(i) (as amended Feb. 17, 2009).

⁴⁹ *Id.*

⁵⁰ *Id.*

and may not fully vest until after repayment of TARP assistance.⁵² Furthermore, the Treasury is explicitly authorized to review bonus awards to senior executives and the top twenty most highly compensated employees to ensure the awards are consistent with the purposes of the TARP.⁵³ The importance of these amendments cannot be overstated. To this author's knowledge, the federal government has never placed explicit limitations such as these on executive pay. Despite the populist attraction, these limits may prove to have many unintended consequences. The bonus limitations apply not only to senior executives but also up to the twenty most highly compensated employees in a covered firm.⁵⁴ This group would likely include some of the financial institution's most successful employees whose pay is highly linked to performance. Many industry experts have warned of a brain-drain from financial firms as the most successful employees exit banks and seek employment with other entities that are not subject to such pay limitations, e.g., hedge funds.⁵⁵ At the very least, the provisions pervert performance based compensation structures effectively ensuring that *more* compensation will be paid in salary, rather than performance-linked awards.⁵⁶ Even Professor Lucian Bebchuk, a long-time critic of existing executive pay practices, vocally opposed these provisions⁵⁷ and criticized the measures as de-linking pay and performance.⁵⁸ The Wall Street Journal reports an investment bank senior executive's telling scenario:

[A] head of commodities trading [is] paid \$10 million in 2008, only \$250,000 of which represented salary. "If you want to keep this commodities trader, you have to increase his salary to \$8 million," . . . But the trader collects that substantial sum even though "you have no idea about

⁵¹ The award value may not exceed one-third of total annual compensation. *Id.* at § 111(b)(3)(D)(i)(II) (as amended Feb. 17, 2009).

⁵² *Id.* at § 111(b)(3)(D)(i)(I) (as amended Feb. 17, 2009).

⁵³ *Id.* at § 111(f)(1) (as amended Feb. 17, 2009).

⁵⁴ The number of highly-compensated employees to which the limits apply depends on the level of TARP assistance the financial firm has received. *Id.* at § 111(b)(3)(D)(ii) (as amended Feb. 17, 2009).

⁵⁵ Mark Maremont and Joann S. Lublin, *Limits on Pay Left Unclear in New Law*, WALL ST. J., Feb. 18, 2009, at A4.

⁵⁶ *Id.*

⁵⁷ Lucian Bebchuk, Op-Ed, *Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 17, 2009, at A15.

⁵⁸ *Id.*

his total performance for the year" -- and the firm can't recoup his salary if his performance falls short⁵⁹

Demonstrating the uniqueness of the crisis, Congress was able to achieve incredible results on "say on pay" legislation which had previously met a dead end in both chambers of Congress. The amendments to the EESA require TARP recipients to institute a shareholder advisory vote to "approve" executive compensation until TARP money has been repaid.⁶⁰ As in the original "say on pay" proposals, the vote is completely non-binding.⁶¹ As of this writing Mr. Obama has made no official indication that general limits on compensation or broader implementation of "say on pay" will be forthcoming; however, administration officials refused to rule out this possibility.⁶² Meanwhile, advocates for pay limitations see the EESA amendments as a large step toward mandatory "say on pay" legislation for all public companies.⁶³

Aside from legislation targeted at recipients of government rescue funds, outright congressional action on executive compensation has been ineffective at reducing compensation levels broadly. As a result, some in Congress have turned to the use of the power of public attention to effect change.

B. New Attempts to Use "Sunshine" as a Cure

The use of congressional hearings to bring public attention to executive compensations issues may be more effective than legislation.⁶⁴ In late 2007, the House Committee on Oversight and Government Reform under the Chairmanship of Representative Waxman engaged in a series of hearings and published findings⁶⁵ questioning the true independence of so-called "independent" compensation advisors.⁶⁶ The report issued by the committee

⁵⁹ Maremont and Lublin, *supra* note 55.

⁶⁰ EESA, Pub. L. No. 100-343 § 111(e)(1) (as amended Feb. 17, 2009).

⁶¹ *Id.* at § 111(e)(2) (as amended Feb. 17, 2009).

⁶² Jane Sasseen and Phil Mintz, *Obama Calls for Executive Pay Limits*, BUS. WK., Feb. 4, 2009, http://www.businessweek.com/print/bwdaily/dnflash/content/feb2009/db2009024_052387.htm (quoting administration officials who have indicated there is no reason why "say on pay" could not apply more broadly).

⁶³ Posting of Ted Allen to Risk & Governance Blog, <http://blog.riskmetrics.com/2009/02/001275print.html> (Feb. 23, 2009).

⁶⁴ See Gretchen Morgenson, *House Panel Finds Conflicts In Executive Pay Consulting*, N.Y. TIMES, Dec. 6, 2007, at C1.

⁶⁵ *Id.*

⁶⁶ Generally, corporate boards delegate compensation structure to a compensation committee made up of independent (non-manager) directors. To assist in its

majority indicated a pervasive phenomenon of conflicted advisors.⁶⁷ Firms frequently provided executive compensation advice to independent compensation committees which determine executive pay while also holding lucrative contracts to perform other services for company management, such as benefits administration.⁶⁸ The majority on the committee inferred that a conflicted advisor is incapable of providing objective compensation advice:⁶⁹ "Consultants who are paid millions of dollars by a corporate CEO won't provide objective advice to the board. They know what the CEO wants to hear, and they know what will happen to their lucrative contracts if they don't say it."⁷⁰

Without attempting to parse through the intentions of the committee,⁷¹ the fact remains that boards' extreme sensitivity to embarrassment⁷² has

determinations and to justify the fairness of decisions, the committee employs "independent" compensation advisors. The notion of independent advisors is central to the appearance of the reasonableness and autonomy of the compensation committee. Corporate Director's Guidebook, Fifth Ed., 62 Bus. Law. 1479, 1526, 1531 (2007); Charles M. Elson, *Executive Overcompensation—A Board-based Solution*, 34 BOS. COLL. L. REV. 937, 976–981 (1993).

⁶⁷ The House committee staff report found that approximately 100 of the 250 Fortune 500 companies surveyed had what it deemed conflicts, meaning that the company hired to advise the compensation committee also did work for the management of the company. H. COMM. ON OVERSIGHT AND GOV'T REFORM, MAJORITY STAFF REPORT ON EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS i (Report 2007) [hereinafter MAJORITY REPORT], available at <http://oversight.house.gov/documents/20071205100928.pdf>. Of course, when dealing with Congress, one must remember it is a primarily political body. Therefore conclusions drawn from a report authored by a single political party should be read with a grain of salt. Cf. H. COMM. ON OVERSIGHT AND GOV'T REFORM, MINORITY STAFF RESPONSE TO THE MAJORITY STAFF REPORT "EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS," (2007), available at <http://republicans.oversight.house.gov/Media/PDFs/20071205staffresponse.pdf> (criticizing the majority report as assuming individuals involved in executive compensation are "bad actors").

⁶⁸ *Executive Pay: The Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 20–22 (2007) (statement of Representative Waxman, Chairman, House Comm. on Oversight and Gov't Reform).

⁶⁹ *Id.*

⁷⁰ *Id.* at 2.

⁷¹ *Id.* at 75–76 (statement by Representative Foxx) (questioning why the House Committee on Oversight and Government Reform is even considering executive compensation).

⁷² Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 927–28 (1993) (noting research demonstrating directors on corporate boards are least interested in serving because of a

stimulated certain changes in corporate boardrooms. Following the hearings, some companies changed practices to ensure the independence of their compensation advisor; a change resulting solely from public attention to the issue.⁷³ Professors Lucian Bebchuk and Jesse Fried have cited lack of independence of compensation consultants to explain unjustifiably high levels of executive compensation.⁷⁴ They also argue that the existence of conflicted advisors further demonstrates the passivity of boards.⁷⁵

Congress may have some ability to use sunshine as a cure to corporate evils; however, the overall effect of such action appears to be limited. Only a few companies have changed their practices as a result of the hearings, and the issue has quickly fallen out of the public light following the conclusion of the hearings. Representative Waxman's committee has found new targets of investigations as it seeks to question fired executives in the wake of the mortgage-backed securities meltdown.⁷⁶

C. Effect of Legislative Action

Considering the history of congressional attempts to reform executive compensation, it becomes obvious that any "hard" measures to modify executive compensation will likely end in unintended distortions along the lines of those that occurred following the amendment of the tax code in 1993 with § 162(m) and perhaps those that will become apparent from the revisions to the EESA.⁷⁷ Members of Congress also have a penchant for choosing pet issues that are likely to engender mention of their name on the evening news, translating into a policy decision less as result of regulatory

pecuniary interest and that sensitivity to public embarrassment presents a real constraint and powerful influence on board actions).

⁷³ As a result of the committee report and the public attention engendered by the hearings, Johnson & Johnson's board, specifically mentioned in the findings as using a conflicted advisor, has since revised its compensation consultant to one that does not also provide other services to the corporation. Experts have indicated that further attention to the issue will result in more changes along the lines of Johnson and Johnson. See Joann S. Lublin, *Theory & Practice: Conflict Concerns Benefit Independent Pay Advisers*, WALL ST. J., Dec. 10, 2007, at B3.

⁷⁴ See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP., 71, 73–74 (2003).

⁷⁵ *Id.* at 73–74.

⁷⁶ *CEO Pay and the Mortgage Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 1–3 (2008). None other than Stan O'Neal became a sitting duck for congressional questioning about his severance package and failure of the credit markets. See *supra* note 10.

⁷⁷ See Miske, *supra* note 31, at 1687; Polsky, *supra* note 31, at 926.

competence than of political aspiration.⁷⁸ History has demonstrated that the fervor against executive compensation is not a new phenomenon, but today's debate is merely one instance in a long history of criticism.⁷⁹ Most importantly, Congress tends to focus on the wrong issue when attempting to regulate executive pay or seeking to give shareholders a ceremonial vote on pay. Today, the ability of shareholders to influence compensation through an advisory vote is practically a non-issue, since stock option grants, which comprise the vast majority of executive compensation, already require an affirmative shareholder vote.⁸⁰ SEC Rules as well as NYSE⁸¹ and NASDAQ⁸² listing requirements dictate that nearly all compensation plans of publicly traded corporations receive shareholder ratification. This effectively moots the arguments that shareholders should receive some sort of vote on pay and serves to strengthen the argument that Congress focuses too much on peripheral issues and not enough on the substantive policy concerns.

If Congress is to play any role, it should focus on the use of "soft measures," such as drawing public attention to relevant matters.⁸³ Although one may disagree with many of the inferences reached by Representative Waxman's report and hearings, the fact that someone is bringing public attention to the issue seems to be a positive step. If the only thing Congress seeks to do is to bring sunshine to corporate board practices, then hopefully

⁷⁸ See, Thomas McCarroll, *Executive Pay: The Shareholders Strike Back*, TIME, May 4, 1992, at 48, ("CEO pay has emerged as a populist issue that no politician can resist.").

⁷⁹ Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 232 (1983) (noting historical examples of movements against executive compensation).

⁸⁰ See Order Approving NYSE and NASDAQ Rule Changes, 68 Fed. Reg. 39,995, 39,995 (July 3, 2003); Press Release, Securities and Exchange Commission, New Rules Require Shareholder Approval of Equity Compensation (June 30, 2003), available at <http://www.sec.gov/news/press/2003-78.htm>.

⁸¹ NYSE, Inc., Listed Company Manual § 303A.08 (2008) ("Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions explained below.").

⁸² NASDAQ Listing Rules § 5635(c) (2008) (Effective April 13, 2009) (previously § 4350(i)), http://nasdaq.cchwallstreet.com/NASDAQ/pdf/new_listing_rules.pdf ("Shareholder approval is required prior to the issuance of securities when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants . . .").

⁸³ Notice how everyone can be happy under this scenario. Those concerned with well-developed policy can take comfort that Congress will not push through an ill-conceived "fix" to a perceived problem while members of Congress can impress constituents with their fight to bring reform to corporate boards.

self-imposed corporate discipline⁸⁴ will regulate the propriety of compensation decisions made by truly independent compensation committees and their advisors.

This latter approach seems most in line with the other forms of effective corporate control. It is difficult to complain about the mere disclosure of one's processes and means chosen to determine executive pay.⁸⁵ Congressional efforts to bring to shareholder and public attention issues that may affect the healthy function of a corporate board are welcome methods to provide reform, if needed, while avoiding actual legal controls which may not provide a solution, or worse, exacerbate the problem.

Government action, however, is only one way to attempt to reform the system of executive compensation. In line with the rise of the issue's prominence, private solutions, via shareholders and shareholder services, have attempted to realign corporate boards where there is a perception that executive compensation is out of line with shareholder interests. These encompass the ability of shareholders to "self-help."

III. SHAREHOLDER SELF-HELP

A recent trend in corporate governance has been the emerging power of shareholder blocs to organize effectively and make proposals⁸⁶ so as to influence the actions of the board of directors.⁸⁷ Traditionally, the board has had almost complete freedom to self-perpetuate with little fear of shareholder ability to organize, based on the diffusion of share ownership and the costs involved in making proposals to the board.⁸⁸ As such, the risk that mangers

⁸⁴ Or barring a self-help approach, at least investor ire may cause boards to listen.

⁸⁵ See discussion *infra* Part IV.

⁸⁶ See Posting of L. Reed Walton to Risk & Governance Blog, http://blog.riskmetrics.com/2008/02/investors_push_for_proposal_ad.html (Feb. 26, 2008) (noting that shareholders continued to push in 2008 for reforms just as they did in the 2007 proxy season. "At least 115 proposals won 50 percent shareholder support or greater in 2007. . . ."); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power* (Univ. of California, Los Angeles, Sch. of Law, Law & Econ. Research Paper Series, Paper No. 05-16, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=783044 (noting, as well, the increasing power of bloc voting by institutional investors).

⁸⁷ Loewenstein, *supra* note 8, at 28 (indicating that recent scholarship tends to demonstrate that on compensation issues, boards that have been the target of bloc shareholder action against executive compensation are likely to increase compensation at a slower rate than comparable firms unaffected by shareholder actions).

⁸⁸ Another possibility is that up until this point, shareholders have exercised their right to be "rationally ignorant" as to the actions of corporate boards. The advent of ever-increasing, negative public attention to executive compensation coupled with decreasing

can extract private benefits from the corporation illustrates the classic agency problem first noted by Berle and Means.⁸⁹

Proxy advisors, whose guidance a number of institutional investors follow closely, have the power of substantial share aggregation behind their recommendations which tends to negate the risk of agency problems and makes boards “all ears.” Outside of institutional investors, activism on the part of smaller and some public shareholders⁹⁰ on hot-button issues has forced boards to consider shareholder sentiment on executive compensation. Finally, hedge funds’ nascent function in corporate governance reform may give them some role to play in shaping executive compensation.⁹¹

A. *The Ascendancy of Proxy Advisors*

The rising importance of proxy advisor services has garnered much attention, particularly among boards of directors and their advisors. Proxy advisors are third-party consultants who, for a fee, provide (mostly) institutional shareholders with advice and analysis on company and director performance as well as recommendations on specific shareholder voting items.⁹² Although originally conceived in the 1980s, proxy advisors, such as RiskMetrics Group/Investor Shareholder Services (RiskMetrics),⁹³ have become increasingly powerful.⁹⁴ Additionally, through industry consolidation,⁹⁵ RiskMetrics in particular has risen to a position of

transactions costs (e.g., proxy services which synthesize and gather information) may have created the perfect storm for shareholder activism.

⁸⁹ See generally, ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1968).

⁹⁰ CalPERS and NYPERS, the public employee pension plans for California and New York respectively, have been two of the most vocal advocates for forcing the hand of the board of directors to explore many proposals, including changes to executive compensation schemes.

⁹¹ See generally Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* (European Corp. Governance Inst., Finance Working Paper No. 139, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948907.

⁹² Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L. J. 269, 294 (2003).

⁹³ RiskMetrics Group was formed in January 2007 through the merger of two large proxy advisors, RiskMetrics and Institutional Shareholder Services (ISS). See RiskMetrics Group, *Company History*, <http://www.riskmetrics.com/history> (last visited March 16, 2009).

⁹⁴ Albert Verdam, *An Exploration of the Role of Proxy Advisors in Proxy Voting* 1–4 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978835.

⁹⁵ *Id.*

tremendous influence in the corporate governance landscape⁹⁶ and in recent years has dominated the industry.⁹⁷

Institutional investors have large, diversified portfolios, often with broad stock ownership across industries. As a result, institutional investors face a tremendous number of divergent issues on which to cast votes. The pressure to fulfill their fiduciary obligation to vote in shareholders' best interest further complicates the decision.⁹⁸ The process to determine how to vote may be time consuming, expensive, and outside an institutional shareholder's area of expertise. For that reason, RiskMetrics and others have created a sort of gold standard on many corporate governance issues, including executive compensation.⁹⁹ RiskMetrics made executive compensation a key issue in its decision to recommend approval of a director nomination.¹⁰⁰ For example, RiskMetrics has recommended withholding votes for certain directors where RiskMetrics has determined that his or her executive compensation practices are out of line with good corporate governance.¹⁰¹

⁹⁶ Choi and Fisch, *supra* note 92, at 294–97 (discussing, *inter alia*, the importance of proxy advisors to modern corporate governance as a result of massive industry consolidation which leaves the market for proxy advisors somewhat monopolized).

⁹⁷ *Id.* at 296.

⁹⁸ For example, the fiduciary duty of an ERISA plan administrator to vote in the investor's best interest. *Id.*

⁹⁹ As Choi and Fisch note, because both the SEC and NYSE require shareholder approval of compensation packages: "approval of stock option plans for many large publicly traded companies will essentially depend on the vote of institutional investors. RiskMetrics' influence over this vote indirectly provides RiskMetrics with the ability to influence executive compensation across all NYSE-listed companies." *Id.*

¹⁰⁰ By way of background, it should be noted that shareholders do not actually elect their choice of directors. Through the proxy, shareholders are asked to approve the board's slate of nominees. Even if the shareholders do not vote, the board's nominations will carry forward. This commonly misunderstood element of corporate governance demonstrates why simply "voting out the scoundrels" is not an effective strategy: the options on a proxy ballot for director nominations is "vote" or "abstain"; one cannot vote "no." William K. Sjostrom, Jr. and Young Sang Kim, *Majority Voting for the Election of Directors* 40 CONN. L. REV. 459, 464–67 (2007). Instead, RiskMetrics and shareholder advocacy groups have campaigned to withhold votes of approval on board nominations where executive compensation is a point of disagreement. While this has no legal effect (one cannot vote "no" to a director nomination), it does get the attention of boards of directors who are sensitive to public reputation and easily embarrassed by large blocs of shareholders withholding approval of the board's recommended slate of directors. See Bebchuk & Fried, *supra* note 74 at 75 ("The tightness of the constraints managers and directors confront depends, in part, on how much 'outrage' a proposed arrangement is expected to generate among relevant outsiders.").

¹⁰¹ Historical examples from the options backdating scandals include withholding votes for directors of Apple in 2006. RISKMETRICS GROUP, 2007 POSTSEASON REPORT: A

Despite the empowerment of institutional shareholders and their investors via a single governance policy, scholars have raised concerns regarding RiskMetrics' "good corporate governance" paradigm.¹⁰² Academics have questioned the value of the RiskMetrics golden standard when RiskMetrics may have conflicts with the corporations it is evaluating and when it furnishes its evaluation criteria to corporations for a fee.¹⁰³ In fact, companies who subscribe can test their compensation plan in advance to determine if RiskMetrics will approve it.¹⁰⁴ Moreover, institutional investors, the main clients of RiskMetrics, may not have the same priorities as individual investors and may not have incentives to seek optimal corporate governance with respect to executive compensation.¹⁰⁵

For legal advisors to boards, RiskMetrics and other proxy services provide great frustration. Practitioners frequently complain that RiskMetrics and other advisors continually change the standards by which it will judge corporate actions.¹⁰⁶ Even if a corporation is able to understand exactly what RiskMetrics believes are the appropriate corporate governance mechanisms for determining compensation, those mechanisms may not coincide with genuine, well-intentioned efforts by management to create shareholder value. The concept that one analysis can be applied across the board to create appropriate controls for executive compensation is a tenuous theory at best.

B. Shareholder Movements

In the 2007 and 2008 proxy seasons, issues of executive compensation were in the spotlight. In the 2004 through 2008 proxy seasons, executive compensation was the number one issue in

CLOSER LOOK AT ACCOUNTABILITY AND ENGAGEMENT 3 (2007), <http://www.riskmetrics.com/sites/default/files/2007PostSeasonReportFINAL.pdf>.

¹⁰² Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. LAW, 887, 906–19 (2007).

¹⁰³ *Id.* See also Choi & Fisch, *supra* note 92 at 298 (“[B]ecause ISS generates substantial revenues from the services that it provides to institutional investors, which include corporate pension funds and other institutions with Wall Street loyalties, ISS may face constraints on its ability to criticize management decisionmaking [sic]. . . . [Additionally,] ISS has recently come under attack for selling issuers access to its corporate governance rating system . . . which the corporation may then use to improve its score dramatically—often by making a series of modest governance changes. *Id.*”).

¹⁰⁴ Rose, *supra* note 102, at 902–3.

¹⁰⁵ Anabtawi, *supra* note 86, at 16–19.

¹⁰⁶ Rose, *supra* note 102, at 901–2 (detailing how RiskMetrics frequently adjusts its metrics); Michael J. Segal, Partner, Wachtell, Lipton, Rosen & Katz, Remarks at The Ohio State University Moritz College of Law (Nov. 15, 2007).

shareholder proposals.¹⁰⁷ See Table 1. Furthermore, according to RiskMetrics¹⁰⁸ many investor groups sought “say on pay” initiatives giving them the right to an annual advisory approval vote on executive compensation, similar to that proposed in Congress.¹⁰⁹ Recent proxy seasons have also seen increased numbers of such initiatives. See Table 1. Although in general, such shareholder proposals rarely succeed, the public scrutiny and pressure placed upon the board of directors may spark change.¹¹⁰ For example, Aflac Inc. and several other companies have voluntarily placed a “say on pay” provision on their annual ballots.¹¹¹

¹⁰⁷ GEORGESON, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW 14 (2008).

¹⁰⁸ RISKMETRICS GROUP, 2008 POSTSEASON REPORT SUMMARY (2008), *available at* http://www.riskmetrics.com/system/files/private/PSR_2008_Short_final.pdf (last visited April 9, 2009).

¹⁰⁹ RISKMETRICS GROUP, 2007 POSTSEASON REPORT: A CLOSER LOOK AT ACCOUNTABILITY AND ENGAGEMENT 8 (2007), *available at* <http://www.riskmetrics.com/sites/default/files/2007PostSeasonReportFINAL.pdf> (last visited April 9, 2009).

¹¹⁰ *See, e.g., id.* at 2 (inferring from the higher number of withdrawn proposals, year on year, that corporate boards are engaging shareholders and voluntarily changing to avoid a shareholder showdown); *see also* Anabtawi *supra* note 86, at 42 (raising concern that large shareholders may bargain with corporations privately and extract private benefits without the benefit of a broader shareholder vote).

¹¹¹ RISKMETRICS GROUP, *supra* note 108, at 5. (Eleven U.S. companies have or will have “say on pay” on their ballot; Aflac’s first “say on pay” vote resulted in 95% approval by shareholders).

Table 1: Shareholder Proposals on Executive Compensation and "Say on Pay"
2004–2008

	2004	2005	2006	2007	2008
Executive compensation proposals ¹¹²	167	133	96	161	132
Proposals as percentage of governance proposals ¹¹³	40.3%	35.5%	24.9%	42.9%	38.9%
"Say on Pay" proposals ¹¹⁴	--	--	7	41	67
Average level of support ¹¹⁵	--	--	40.1%	41.7%	42.1%

Of course, beyond just soliciting support for shareholder proposals, the costs of placing a shareholder measure on the ballot are tremendous.¹¹⁶ Although RiskMetrics is actively involved in corporate governance issues, it remains a "passive" organization in that it does not actively place measures on annual ballots. Historically, shareholder initiatives have been initiated by large public pension plans (e.g., CalPERS) and unions.¹¹⁷ In 2007 and 2008, unions alone sponsored 40% and 31%, respectively, of corporate governance ballot initiatives.¹¹⁸ As such, the proposals may not have the grassroots background that the term shareholder activism implies. More often than not, a particular interest group with its own agenda is behind the proposal.¹¹⁹ As with RiskMetrics, the motivation of those seeking the specific action can fairly be questioned as to whether it is truly in the best interest of

¹¹² GEORGESON, *supra* note 107, at 14, Figure 3.

¹¹³ *Id.*

¹¹⁴ For the 2008 figure, *see id.* For 2005, 2006, and 2007, *see* RISKMETRICS GROUP, *supra* note 109 at 6, Chart 1.

¹¹⁵ RISKMETRICS GROUP, *supra* note 108, at 3, Chart 1.

¹¹⁶ At least when a proxy contest is involved. For a simple shareholder proposal without binding effect a simple 14a-8 resolution could be implemented. *See generally* Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78(n)(2006).

¹¹⁷ Stewart J. Schwab and Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism By Labor Unions*, 96 MICH. L. REV. 1018, 1029 (1998).

¹¹⁸ GEORGESON, *supra* note 107, Figure 7.

¹¹⁹ In 2008, only 48% of governance proposals were initiated by individual investors. *Id.*

shareholders and whether it is in line with optimal corporate governance. Union-sponsored proposals may be simply masked attempts to exert pressure over management for bargaining concessions, pension plans may be seeking particularized advantages for their constituents, and finally, some organizers may be seeking a pay-off by the corporation to withdraw the proposal.¹²⁰

C. Private Action Has Potential

RiskMetrics provides some power to institutional shareholders to avoid the collective action problem by providing a clearing mechanism by which egregious abuses in executive compensation can be mitigated. However, the biggest hurdle remains the cure. While RiskMetrics may be advantageous as a uniform “rule-making” body, its interest in objective, general shareholder value is questionable in light of its clients and its profit motivation. Research has increasingly indicated that corporations that have adopted proxy advisor recommendations do not show noticeable increases in shareholder value.¹²¹ While some scholars have pointed to hedge funds as the next tool by which greater corporate governance can be achieved, hedge funds typically have not focused on executive compensation when attempting to implement corporate reform. Although research in this area is growing, some preliminary reports did find when a hedge fund becomes involved in a corporation, executive compensation levels equilibrate to more closely match that of peer firms.¹²² However, the long term implications of hedge funds are far from known.

One must conclude that proxy advisors and shareholder measures are possible tools to enforce reasonableness among corporate boards through the threat of action. Corporate boards may be able to self-regulate because of the threat of action by activist shareholder campaigns. This is all less likely absent transparent disclosure, thus Part IV discusses the new SEC Disclosure Rules.

IV. NEW SEC RULES ON DISCLOSURE OF EXECUTIVE COMPENSATION

Unlike shareholder proposals which are merely precatory, the SEC, as a regulatory body, has the power to bind corporations under its rules and

¹²⁰ See Choi & Fisch, *supra* note 92, at 301 (discussing the numerous conflicts that may be involved in any given shareholder proposal).

¹²¹ See generally, Robert Daines et. al., *Rating the Ratings: How Good are Commercial Governance Ratings?* (Stanford Law & Econ. Olin Working Paper No. 360, 2008), available at <http://www.gsb.stanford.edu/cldr/cgrp/documents/dgl6-26-2008.pdf>.

¹²² Brav, *supra* note 91, at 32–34.

regulations.¹²³ Moreover, as opposed to Congress, the SEC is clearly in a superior position in terms of institutional competence to deal with questions regarding executive compensation.¹²⁴ Thus, the SEC is best situated to provide an enforceable and appropriate response to any contention, real or perceived, that executive pay is out of step with good corporate governance.¹²⁵

In response to increased public attention over executive compensation, the SEC's new rules on executive compensation disclosure seek to place information in the marketplace and permit investors to determine the advisability of a corporation's compensation structure. The remainder of the Note will focus on this important development by looking into the context of the new rules, the new rules themselves, the application of those rules, and their prospective impact on executive compensation.

A. Background

Through the Securities Act of 1933 and the Exchange Act of 1934, Congress set up requirements, enforced by the SEC's rulemaking authority, for the disclosure of executive compensation.¹²⁶ Since the '33 and '34 Acts, the SEC has created rules which specify in greater detail how and to what extent covered corporations must disclose compensation.¹²⁷ In the early days of disclosure, the SEC required a combination of narrative description and tabular description to detail compensation.¹²⁸ In the narrative discussion, companies explained their compensation policies rather than focusing on hard numbers and the comparison of those numbers over time.¹²⁹ In the

¹²³ Securities Exchange Act of 1934, 15 U.S.C. § 78(d) (2006) (establishing the Securities and Exchange Commission (SEC) and imbuing it with rulemaking authority).

¹²⁴ Although the SEC does not regulate the level of compensation, it has a long history of regulating the disclosure of executive compensation. *See* JAMES HAMILTON, EXECUTIVE COMPENSATION AND RELATED-PARTY DISCLOSURE 13, 15 (2006) (noting the SEC does not set compensation but regulates its disclosure with the first disclosure regulations dating to 1938).

¹²⁵ At least with respect to some aspects of procedural fairness, but mostly with respect to disclosure. *See id.*

¹²⁶ Schedule A, Item 14 of the 1933 Securities Act provides that remuneration shall be disclosed. 15 U.S.C. § 78(l)(b) (2006). Section 12(b) of the Exchange Act requires disclosure of any securities given, including stock options, which in modern times accounts for the largest portion of executive compensation 15 U.S.C. § 78(l)(b) (2006).

¹²⁷ *See* HAMILTON *supra* note 124, at 12.

¹²⁸ *See* Securities Exchange Act of 1934 Amended Proxy Rules, 3 Fed. Reg. 1991 (Aug. 13, 1938); Final Rule: Executive Compensation and Related-Party Disclosure, 71 Fed. Reg. 53,158, 53,160 (Sept. 8, 2007) (codified at various).

¹²⁹ 71 Fed. Reg. at 53,160.

tabular approach, the corporation did focus on the numbers with the ability for the investor-public to see changes in the company's compensation practices over time.¹³⁰

The rules preceding the current rules, last amended in 1992, shifted the focus from narrative disclosure to a greater emphasis on the tabular approach.¹³¹ Behind the 1992 changes, the SEC reasoned that tables would more clearly show the changes of executive compensation over several years;¹³² however, many have noted that those tables, while providing some clarity, no longer reflect an accurate picture of executive compensation, particularly in light of the 1993 amendments to the Internal Revenue Code discussed *supra* Part II.A. and the resulting compensation shift away from salary and towards equity awards.¹³³ Concomitant to this shift, many companies moved more compensation into perquisites and into other so-called "stealth" compensation.¹³⁴

As executive compensation has become a politically charged issue over the last several years, the SEC has been under pressure to use its regulatory authority to "do something" about executive compensation.¹³⁵ The SEC

¹³⁰ *Id.* This also gave the ability to measure compensation with the company's historical performance. Prior to 1992, the focus was on the narrative portion of the disclosure. *Id.*

¹³¹ See Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, 58 Fed. Reg. 63,010-01 (Nov. 29, 1993) (codified at 17 C.F.R. §§ 228, 229, 240 (2008)).

¹³² HAMILTON *supra* note 124, at 12; Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,160 (codified as amended in scattered sections of 17 C.F.R.).

¹³³ As mentioned earlier, the million dollar salary deduction cap in § 162(m) of the Internal Revenue Code has been cited by scholars as an impetus towards increased use of performance based compensation, notably stock options. See Miske, *supra* note 31.

¹³⁴ Many scholars have noted an increase in compensation complexity since 1993. Some have alleged the use of opaque compensation schemes in order to mask actual compensation. For a discussion of such "stealth" compensation, see Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291 (2004). But see Joseph Gerakos, CEO Pensions: Stealth Compensation or Arm's Length Contracting? (Oct. 28, 2006) (unpublished manuscript, available at <http://irm.wharton.upenn.edu/F06-Gerakos.pdf>) (finding empirical data indicates that boards do not grant "excessive" pension plans and that companies do not use disclosure rules to hide such payments). See also David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 607 (2007) (noting the use of backdated options to achieve stealth compensation).

¹³⁵ Roel C. Campos, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the 2007 Summit on Executive Compensation (Jan. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch012307rcc.htm>. The Commissioner begins by stating that the SEC is not in the business of regulating the level of compensation; however, the majority of his remarks focus in the intense scrutiny surrounding

obliged, and in 2006 issued new rules amending disclosure regulations and dramatically changing the landscape of corporate reporting of executive compensation.¹³⁶

Scholarship relating specifically to the changes that were made, their impact, and an assessment of how executive compensation is likely to change as a result of the new rules is limited but incipient.¹³⁷ The remainder of this Note will focus more acutely on the implementation of the new SEC disclosure rules, including discussion of the SEC's assessment of the first year of implementation, 2007 as well as its general comments from the 2008 proxy season. Finally, this Note will consider potential effects on executive compensation and those corporations which must comply with the new rules.

B. *The Amendments Themselves*

While this Note will attempt to steer clear of the ultra-technical aspects of the SEC amendments to disclosure requirements,¹³⁸ a discussion of major

compensation issues by the media and Congress. *Id.* One can read between the lines that the Commissioner hopes that the new rules will go a long way toward improving confidence in the process by which executive compensation is determined. *Id.* "The Commission is trying to help in this regard [making boards more aware of the executive compensation systems already in place]. Generally speaking, I think the breadth and specificity of our new executive compensation rules will have the effect of focusing compensation committees on the details of executive compensation packages." *Id.*

¹³⁶ Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), available at <http://www.sec.gov/news/press/2006/2006-123.htm>. The regulations which were finalized in July 2006 officially went into effect for proxy statements on December 15, 2006 for compliance with the 2007 proxy statements that were issued. *Id.* at § 7.

¹³⁷ See, e.g., Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481 (2007); Kenneth M. Rosen, "Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation, 76 FORD. L. REV. 2907 (2008). Despite a few noted examples, scholarship on this topic remains sparse except for practitioner focused articles. This is likely due to the recency of the decision as well as the uncertainty of how it will be implemented and enforced.

¹³⁸ For detailed analysis of the changes implemented, see Final Rule: Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,158-59 (codified as amended in scattered sections of 17 C.F.R.). The report notes the specific section of the Code of Federal Regulations affected by each substantive amendment. For commentary on the changes in more technical detail see Mark Watson et al., Moody's Investor Serv., Special Comment, *A User's Guide to the SEC's New Rules for Reporting Executive Pay*, April 2007, <http://ssrn.com/abstract=987914>.

changes is critical to understanding and assessing compliance with the measures.¹³⁹

The most notable change to compensation is a return to an intense focus on the narrative portion of compensation disclosure.¹⁴⁰ Under the new SEC regulations, companies will be required to include a new section, the Compensation Discussion and Analysis (CD&A).¹⁴¹

The new CD&A is marked by the SEC's attempts to expand and explain the tabular portion of the proxy statement.¹⁴² The SEC envisions that the CD&A will require compensation committees to put down in writing not only the philosophy behind the company's compensation decisions but also specific reasons for why a company arrived at a particular compensation decision.¹⁴³

Although the CD&A encompasses the most significant revisions to proxy disclosures, other notable changes include an expanded and more comprehensive set of tabular disclosures designed to make easy comparison between years and between company performance and pay.¹⁴⁴ The new regulations also implement various revisions to Regulation S-K, Item 402 (disclosure dealing mainly with the numerical representations of executive compensation).¹⁴⁵ "The changes to Item 402 take a broad approach that

¹³⁹ For an excellent review of the changes as well as explanations, see HAMILTON, *supra* note 124.

¹⁴⁰ *Id.*

¹⁴¹ See *id.*; 71 Fed. Reg. at 53,161–64. The CD&A has been advocated by some academics previous to the SEC's adoption and notably is used as part of the U.K.'s corporate governance regime. Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L., 675, 698–701 (2005). Interestingly, the U.K. also has a mandatory shareholder advisory vote for executive compensation. *Id.* Recent scholarship from Yale's School of Management has suggested that adoption of these U.K.-style corporate governance schemes would be beneficial to shareholder interests by increasing dialogue between shareholders and the boards that are intended to represent them. Stephen Davis & Stephen Alogna, *Talking Governance: Board/Shareowner Communication*, THE CORPORATE BOARD, Sept./Oct. 2008, available at <http://mba.yale.edu/faculty/pdf/0809-DavisAlogna.pdf>.

¹⁴² See 71 Fed. Reg. at 53,160.

¹⁴³ See *id.* at 53,164; HAMILTON, *supra* note 124, at 27 (noting that the SEC wants the CD&A to allow investors to see executive compensation through the eyes of the compensation committee through "a principles-based overview explaining the policies and decisions related to named executive officer compensation. . .").

¹⁴⁴ *Id.*; 71 Fed. Reg. at 53,160 (codified as amended in scattered sections of 17 C.F.R.) (Sept. 8, 2006).

¹⁴⁵ This is an obvious attempt to address concerns noted *supra* note 134 concerning stealth compensation. The SEC seeks to require the company, subject to prosecution for material misstatements, to set a single number that will account for compensation of all

would eliminate some tables, simplify or refocus other tables, [to] reflect total current compensation... and be sufficiently flexible to operate effectively as new forms of compensation continue to evolve.”¹⁴⁶

For many corporations, this has likely been a painful process. As noted previously, boards and executives are surprisingly sensitive to reputation effects of bad press regarding compensation decisions.¹⁴⁷ Perquisite disclosure is particularly prone to embarrassment. Under the new rules, corporations must disclose perks when the total value exceeds \$10,000 (reduced from \$50,000).¹⁴⁸ The rules no longer allow vague classifications, such as “travel expenses” but require a more detailed explanation.¹⁴⁹ This often will take the form of explicit disclosures stating, for example, the number of hours the executive has personal use of a corporate jet and, even more incendiary, the amount of tax gross-ups paid.¹⁵⁰ In response to the required disclosure, some companies have already taken steps to reduce or eliminate embarrassing perks.¹⁵¹

At Sunoco, CEO John G. Drosdick has asked the company to stop paying tax gross-ups on personal travel when using the corporate jet, according to the oil company's proxy statement. Drosdick also has given up his company-

kinds received by the executive, e.g., use of private jet, country club dues paid, deferred compensation agreements, or retirement plans. *See also*, Gopalan, *supra* note 30 at 224–26 (rules as an attempt to shed light on stealth compensation).

¹⁴⁶ HAMILTON, *supra* note 124, at 39. New disclosure rules will encompass not only salary and bonus but all compensation, pensions and perquisites included. *Id.* The SEC has also carefully defined required disclosures to ensure a broad reading that would include future innovations and changes in executive compensation practices. *Id.*

¹⁴⁷ *See* Bebchuk, Fried, and Walker, *supra* note 23 at 786–89 (showing that directors are very sensitive to investor outrage over executive compensation and attempt to avoid it).

¹⁴⁸ HAMILTON, *supra* note 124, at 61.

¹⁴⁹ *Id.*

¹⁵⁰ The amount of additional payment given to the executive to cover the taxable cost of a given perk. In the corporate jet example, the company would cover the cost of the tax the executive would have to pay in additional income tax because of the perk. Intuitively, this type of compensation provokes an especially visceral reaction from many shareholder advocates.

¹⁵¹ Erin White and Joann S. Lublin, *Full Disclosure: Companies Trim Executive Perks to Avoid Glare*, WALL ST. J., Jan. 13, 2007, at A1. (indicating that 14 of 110 companies surveyed in just the first year of the new disclosure rules indicated that they had decided to drop or were considering dropping certain perquisites). *Id.*

leased car, country club dues, and financial planning service allowances formerly provided by the firm.¹⁵²

Finally, the last change addressed in this Note is a broad requirement that essentially non-technical disclosures be provided in “plain English.”¹⁵³ This requirement is significant and is an attempt to avoid lawyers’ tendency to use legalese and boilerplate when crafting disclosures.¹⁵⁴

C. SEC Observation on Compliance

In August 2007, the SEC issued staff observations based on its detailed review of the disclosure of several hundred companies and their attempts to implement the new executive compensation rules.¹⁵⁵ The report was largely complimentary towards good faith efforts to comply with the new rules especially with respect to tabular and the hard-number calculations of executive compensation.¹⁵⁶ The SEC did note pervasive deficiencies in its aspirations for the CD&A.¹⁵⁷ Unsurprisingly, corporations and their legal advisors, did not meet the SEC’s aspiration for a “plain English” analysis of executive compensation.¹⁵⁸ Even some outside observers have remarked that the hoped for explanation of compensation in the CD&A section became a melting pot of boilerplate and legalese.¹⁵⁹ This is at least partly due to the fact that requiring filing of compensation philosophy and specific reasons for

¹⁵² Posting of L. Reed Walton to Risk & Governance Blog, http://blog.riskmetrics.com/2007/06/a_closer_look_at_perkssubmitte.html (June 15, 2007) (referencing the Sunoco proxy statement).

¹⁵³ 17 C.F.R. § 240.13a-20 (2008) (“Any information included or incorporated [in specified sections of disclosure] must be presented in a clear, concise and understandable manner.”).

¹⁵⁴ HAMILTON, *supra* note 124, at 24 (discussing the plain English requirement as an attempt to avoid “legalistic or overly complex presentations . . . boilerplate . . . [and repeated disclosures] that increase the size of the document but [do] not enhance the quality of the information.”).

¹⁵⁵ DIV. OF CORPORATE FIN., U.S. SEC. & EXCH. COMM’N COMMISSION, STAFF OBSERVATIONS IN THE REVIEW OF EXECUTIVE COMPENSATION DISCLOSURE (2007), available at <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ See Watson et al., *supra* note 138 at 9 (“Moody’s is concerned that the additional legal burden attributed to filing the CD&A will encourage companies to veer towards legalese and boilerplate disclosures. Although it is still too early to be conclusive, Moody’s has found that many of the proxy statements already filed with the SEC in 2007 include long and often convoluted CD&As.”)

compensation of a particular named executive would arguably require the corporation to state essentially that the compensation itself is fair.¹⁶⁰

Generally, with respect to the major changes discussed in this Note, the companies have not yet achieved the level of compliance satisfactory to the SEC, except with respect to total compensation numbers and hard figure calculations. Lawyers have prodigiously worked to add enough disclosures and to obscure the analysis through boilerplate in order to shield companies in this regard.¹⁶¹

These observations followed from the SEC's extensive review of disclosure under the new rules after the 2007 proxy season, the first year of implementation.¹⁶² For 2008, the SEC did not engage in the same exhaustive review, but did make several general observations. Not surprisingly, the SEC noted that companies continued to provide inadequate, substantive analysis of compensation policies.¹⁶³ The SEC also indicated that areas for improvement would include disclosure of performance targets and benchmarking disclosure.¹⁶⁴

In this vein, the SEC's general commentary for 2008 focused on failures in two of the most important aspects discussed in this Note, the CD&A (specifically "analysis") and the plain English requirement. Looking to specific examples of the SEC taking exception to actual attempts to comply with the new regulation is helpful to understanding the general tenor of the SEC's intentions.

D. Bristol-Myers Squibb Case Study

Below is a case study on Bristol-Myers Squibb's (BMS) 2007 season 14A disclosure. In looking at particular disclosures as well as SEC objections, the effectiveness of the disclosures and the attempts by boards to limit liability becomes more apparent. BMS provides a good example of the

¹⁶⁰ See discussion *infra* at Part IV.E.

¹⁶¹ In an almost humorous note, in its staff observations, the SEC specifically pointed out that where it makes suggestions that companies can improve on their disclosure—less is more. "Where we ask a company to add analysis, or enhance its analysis, we do not necessarily think that it should lengthen its disclosure. Rather, careful drafting consistent with plain English principles could result in a shorter, more concise and effective discussion that complies with our rules." DIV. OF CORPORATE FIN., U.S. SEC. & EXCH. COMM'N, *supra* note 155.

¹⁶² John W. White, Director, SEC Division of Corporate Finance, Remarks, *Executive Compensation Disclosure: Observations on Year Two and A Look Forward to the Changing Landscape for 2009*, Oct. 21, 2008, available at <http://www.sec.gov/news/speech/2008/spch102108jww.htm>.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

types of general remarks many companies received from the SEC during the 2007 review process as well as examples of how companies attempted to insulate themselves from too much exposure. Particularly, the CD&A disclosure formed an important part of the SEC's comments to proxy filers. The following elements are to be included in the CD&A:

- (1) objective of the compensation program
- (2) actions of the company rewards through compensation program
- (3) individual elements included in the compensation program
- (4) rationale supporting particular elements in the compensation program
- (5) reasoning behind the amounts chosen for each element
- (6) how the choices surrounding the element fit with the compensation objectives as a whole.¹⁶⁵

As opposed to some CD&A disclosures, which were criticized for the lengthiness, BMS's disclosure took a brief and vague approach.¹⁶⁶

Bristol-Myers Squibb's executive compensation program is based on a philosophy of pay-for-performance. . . . [C]onsideration is given to performance against financial objectives and operational objectives consistent with the company's business strategy and total stockholder return. Consideration is also given to an executive's demonstration of [company] values and behaviors All elements of executive compensation are reviewed both separately and in the aggregate to ensure that the amount and type of compensation is within appropriate competitive parameters and the program design encourages the creation of long-term stockholder value.

Another important aspect of the company's compensation program is to adopt policies which reflect a commitment to good corporate governance practices.¹⁶⁷

The language used by BMS appeared to be largely borrowed from its previous year proxy statement with little change, despite the new focus by the SEC regulations on the importance of the descriptive narrative portion of disclosure.¹⁶⁸ In this excerpt, the majority of BMS's CD&A focused on

¹⁶⁵ See Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,164 (codified as amended in scattered sections of 17 C.F.R.).

¹⁶⁶ Bristol-Myers Squibb, Definitive Proxy Statement (Schedule 14A) at 17 (Mar. 22, 2007).

¹⁶⁷ *Id.* at 17–18.

¹⁶⁸ Bristol-Myers Squibb, Definitive Proxy Statement (Schedule 14A) at 18 (Mar. 22, 2006).

explain briefly why the mentioned component amounts that comprise his pay are so much greater than those of the other directors.”¹⁷⁵

Another interesting comment concerned the employment contract of the temporary CEO. BMS offered what appears to be a fairly detailed, bulleted summary of the employment terms of the temporary CEO.¹⁷⁶ In this instance, it seems as if the SEC thinks the company has said too much: “Disclose in this subsection only a clear and concise summary of the material terms and conditions of Mr. Cornelius’ employment agreement.”¹⁷⁷ However, though the details of the plan were too great, the explanation of the individual terms was too little: “analyze why the employment agreement was designed and structured to provide the mentioned material compensation elements and levels.”¹⁷⁸ At this point, it seems that BMS is trapped in the SEC’s version of Goldilocks and the Three Bears, leaving BMS searching for the Golden Mean.

In 2008, BMS took much of the SEC commentary to heart. In 2007, BMS used approximately 7,000 words¹⁷⁹ in its CD&A section, while in 2008, it used over 10,000 words.¹⁸⁰ Although length is not necessarily an indication of quality, the disclosures in 2008 were much more analytical and included charts and greater explanation for individual executive compensation decisions as the SEC had requested.¹⁸¹

E. Possible Effects of More Rigorous Disclosure

This leads to the question of what effect the new rules will produce both in terms of actual effect on compensation and on potential liability for corporations. With respect to liability, the SEC has suggested that the CD&A should in many ways be parallel to the Management Discussion and Analysis (MD&A) already established.¹⁸² One should be able to draw reasonable

¹⁷⁵ *Id.*

¹⁷⁶ Bristol-Myers Squibb, Definitive Proxy Statement *supra* note 166, at 31–33. The summary even mentions whether or not the interim’s utility bills will be paid on his apartment in New York City. *Id.* at 27.

¹⁷⁷ Bristol-Myers Squibb, SEC Comment Letter *supra* note 170, at 3.

¹⁷⁸ *Id.*

¹⁷⁹ Bristol-Myers Squibb, Definitive Proxy Statement, *supra* note 166.

¹⁸⁰ Bristol-Myers Squibb, Definitive Proxy Statement (Schedule 14A) at 20 (Mar. 24, 2008).

¹⁸¹ *Id.*

¹⁸² John W. White, Director, SEC Division of Corporate Finance, Remarks at The Practising Law Institute Conference (Sept. 6, 2006), *available at* <http://www.sec.gov/news/speech/2006/spch090606jww.htm> (“MD&A is an especially

parallels between MD&A liability and CD&A liability. The new rules require the CD&A and other important new components of executive compensation disclosure to be “filed” with the SEC, not simply “furnished”.¹⁸³ When documents are “filed” with the SEC, the risks involved with inaccuracies are raised as liability for material misstatements is heightened.¹⁸⁴ In addition to regular misstatement or omission liability, a “filed” document will fall under the class of information which the CEO and CFO must certify under Sarbanes-Oxley § 302.¹⁸⁵ While it is unlikely that a large number of civil lawsuits will result¹⁸⁶, SEC enforcement actions would subject the company to increased risk for liability for misstatements.

This exposure to liability will incentivize companies to provide air-tight and opaque disclosure, yet the SEC has evinced a policy towards simple, clear, and concise explanations of the executive compensation policy. This clash could lead to pushing companies towards liability for material misstatements.¹⁸⁷ Since 1992, the SEC has prosecuted corporations for

good starting point for the new, equally principles-based, Compensation Discussion & Analysis, or CD&A”).

¹⁸³ Under previous disclosure regulations, much of the disclosure portion of the proxy statement involving narrative was not *filed* with the SEC but was merely *furnished* to shareholders. By requiring corporations to file, the SEC is opening boards up to liability for material misrepresentations or omissions under Rule 14(a)(9) and Section 18 of the Securities and Exchange Act of 1933.

¹⁸⁴ HAMILTON, *supra* note 124, at 28 (“The CD&A would be . . . filed [and] . . . would be subject to . . . the liabilities of Exchange Act Section 18.”). Section 18 of the Securities Exchange Act of 1934 provides for civil liability to any party who bought or sold securities where the company had filed material misleading statements. 15 U.S.C. 78(r) (2000). Under Rule 10b-5, the go-to for material misstatements, there is similar civil liability, however, a successful 10b-5 action must establish scienter. There is no such scienter requirement for Section 18 liability. *Id.* Consequently, firms may find themselves subject to increasing numbers of lawsuits for misstatements, without the protection of a scienter requirement. See LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 9–11 (4th ed. 2004).

¹⁸⁵ Sarbanes-Oxley Act of 2002, Pub.L. 107-204, § 302 (2002).

¹⁸⁶ Recovery under 10b-5 must involve a showing of scienter, which is difficult to prove. Alternatively, a recovery under § 18 requires a showing of reliance, effectively eliminating any class action potential and at the same time, the incentive for plaintiff attorneys. Section 14a-9 may provide some potential for civil suits, since there is no scienter requirement; however, proving damages in a civil suit may prove challenging. It would depend to what extent a misstatement or omission regarding executive pay programs would result in decreased corporate value and would likely be a negligible sum.

¹⁸⁷ Under the 1933 Securities Act § 12(b) a public corporation is required to comply with regulations and is liable for material misstatements. 15 U.S.C. § 78(r) (2000). The SEC can bring enforcement actions against corporations that fail to comply with the rule; however, private shareholders may also bring private rights of action against boards for

failure to comply with the MD&A requirements of federal securities regulation.¹⁸⁸ These proceedings range from material misstatements or, analogous to the CD&A complaints, failing to provide a full and clear picture of all the company's operations.¹⁸⁹

One can imagine the delicate balance that legal advisors and corporations will face when attempting to comply with SEC requests for a more plain and simple compensation analysis. In simplifying, the company is complying with the SEC guidelines and is unlikely to face official enforcement actions; however, in eliminating many of the "legalese" as the SEC puts it, the company may be opening itself to other litigation for material misstatements or for filing a misleading analysis of executive compensation. These are significant questions that have yet to be answered.

Aside from the potential liability based solely on the traditional tools for misstatement litigation, one of the strongest arguments against the filing requirement comes from that fact that by filing, the chief executive must certify the statements pursuant to Sarbanes-Oxley, attesting to the accuracy of the CD&A developed by the compensation committee.¹⁹⁰ This engenders personal, criminal liability for a process from executives which they should be substantially removed. According to best practices, executives should not be involved in the compensation committee's deliberations, yet by exposing the CEO and CFO to personal liability, the rules may provide great incentives to become involved.¹⁹¹ Increased personal liability for executive and directors through SOX litigation or other liability will not decrease aggregate executive compensation. Executives and directors will demand more compensation for the added risk associated with their position. The threat of litigation will weigh heavily on their decision to accept a particular compensation level.

Another possible result of the new disclosure rules could implicate Delaware law. Up to this point, Delaware has not become involved in executive compensation regulation, even in the face of particularly egregious facts such as those in *In re The Walt Disney Co. Derivative Litigation*.¹⁹² In this derivative action, shareholders accused the board of directors of failing to act responsibly with respect to the compensation of Michael Ovitz who

material misstatements under Rule 10b-5. 17 CFR § 240.10b-5. It is the latter action that poses the greatest threat to corporations.

¹⁸⁸ See, e.g., *In the Matter of Caterpillar Inc.*, 50 S.E.C. 903 (1992).

¹⁸⁹ See *SEC v. Sony Corp.*, 67 S.E.C. Docket 1650 (1998).

¹⁹⁰ HAMILTON, *supra* note 124, at 28

¹⁹¹ *Id.* ("[The filing requirement] would inappropriately insert the principal executive and financial officers into the compensation committee's deliberations and potentially impair the committee's independence.").

¹⁹² 907 A.2d 693 (Del. Ch. 2005).

left the corporation after only a few weeks of work with a \$130 million exit package.¹⁹³ Despite sharp criticism, Chancellor Chandler upheld the compensation determination as falling within the business judgment rule and, finding no evidence of “bad faith” or fraud, held the board was immune from litigation for an accounting.¹⁹⁴ The Supreme Court of Delaware upheld the Chancery court decision and affirmed that in Delaware there is little shareholders can do to litigate executive compensation issues, at least for now.¹⁹⁵

This follows from a logical path. Corporate board decisions are evaluated under a “rational business purpose” standard and are protected by the business judgment rule.¹⁹⁶ As the Court held, executive compensation decisions are similarly insulated by the presumption that boards make informed business decisions and that judges should generally defer to that judgment.¹⁹⁷ As long as there is no indication of “fraud, deceit, or self-dealing” the Court will presume the board acted in the shareholders’ and corporation’s best interest.¹⁹⁸ This is precisely why compensation advisors are so important to the compensation committee’s decision making process.¹⁹⁹

Such a deferential standard is typical of Delaware corporate law, but Delaware will guard its favored status and its ability to regulate its own corporations. More and more encroachment by the federal government into this area, typified in the new disclosures, could push the Delaware Chancery

¹⁹³ *Id.* at 697; *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 57 (Del. 2006).

¹⁹⁴ *Id.* at 778–9.

¹⁹⁵ *See In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 75 (Del. 2006) *affirming In re The Walt Disney Co. Derivative Litigation*, 907 A.2d 693 (Del. Ch. 2005).

¹⁹⁶ *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Aronson v. Lewis* 473 A.2d 805, 812 (Del. 1984) (business judgment is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”).

¹⁹⁷ *See In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 73 (Del. 2006). Although the Delaware Chancery Court and Delaware Supreme Court upheld the use of the business judgment rule with respect to shareholder litigation on executive compensation issues, scholars have argued this should not be the case. It is possible that other states will not follow Delaware and instead will use another standard to evaluate compensation decisions in future shareholder litigation outside Delaware. For a discussion of why the business judgment rule should not apply to executive compensation decisions, see Jeremy Telman, *The Business Judgment Rule, Disclosure and Executive Compensation*, 81 TUL. L. REV. 829 (2006).

¹⁹⁸ *In re The Walt Disney Co. Derivative Litigation*, 907 A.2d at 746–47.

¹⁹⁹ *Id.* at 38–40; *see also* discussion *supra* at Part III.B..

to reconsider its non-interventionist position in the face of regulatory competition. Many academics have called for the Chancery to reconsider its reasoning from *Disney* in light of subsequent cases and have encouraged the court to become more activist with respect to executive compensation.²⁰⁰

Disclosing how boards arrive at their decision, the performance benchmarks they use, and fancy charts may be very enlightening, but it will not change the number at which the corporation arrives. As with other regulatory formalities, the compensation committee has great incentives to devise the CD&A *around* the final number they choose. Instead of seeing CD&A as a template for the analysis of executive compensation, lawyers will logically develop a good paper trail which demonstrates how informed and rational the board was in its decision. CD&A will not change the level of compensation.

Instead, the SEC should focus more intently on the tabular, hard-number disclosures. The CD&A will mean little to institutional investors and analysts, who will care little of the process and safeguards the board uses to achieve compensation decisions (and understand them for what they are), however, they will be significantly more interested in the actual compensation awarded. The new disclosure rules should be lauded for attempting to arrive at a single compensation figure, including compensation of all types and which cannot be hidden under a separate footnote. This single number will allow investors to compare executive pay across time and importantly across companies with some level of accuracy. Peer firms will be compared together based on performance. In this situation, it is far more probable that executive pay will be questioned when it does not stack up to the competition.

V. WHERE FROM HERE

A review of history leads to the conclusion that no matter what Congress, shareholders, or the SEC attempt, nothing is new under the sun. The current discourse on executive pay is not the first, nor will it be the last.²⁰¹ Even the

²⁰⁰ After *Stone v. Ritter*, some academics have called for increased judicial participation in executive compensation issues. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (hinting that *Disney* is really a duty of loyalty case and that the good faith element found in that case is really part of the duty of loyalty); Claire A. Hill and Brett H. McDonnell, *Essay: Stone v. Ritter and the Expanding Duty of Loyalty* (University of Minnesota Law School Legal Studies Research Paper Series No. 07-35, 2007, available at <http://ssrn.com/abstract=1008930> (arguing for an expansion of the duty of loyalty after *Stone v. Ritter*).

²⁰¹ Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 149 (2006) (noting that a similar movement to fix executive compensation occurred in the early 1990s resulting in the 162(m) change to the

most prominent advocates for reform have acknowledged that little can be expected from these efforts.²⁰² The provisions in the amendments to the TARP program excepting, there have been no successful attempts by government to forcefully decrease executive pay.

With that said, what to do? Even without determining if a problem exists, the goal should be to increase market efficiency and value for the economy, for shareholders, and for corporations. Congress cannot be relied upon to provide a meaningful solution within these parameters. Efficiency is hardly its biggest concern and politics are likely to impede any forthright discussion of the issues. Although actions by private groups of shareholders or proxy advisors may seem to be an efficient solution, the motivation behind such activism often underlies a more elaborate agenda than mere improvements in corporate governance.²⁰³ This leaves the SEC's new proposals. They are broad, sweeping, and could be a powerful force.

As noted, executives and especially directors are sensitive to public perception and embarrassment. Executives want to maintain a solid reputation in order to move to the next position,²⁰⁴ and directors, whose motivation to serve on boards is usually not for pecuniary gain, have social and business reputations they do not wish to tarnish.²⁰⁵ Already, executive compensation systems are being changed, even if slightly, in response to the required "plain language" disclosure requirement of certain types of compensation and an attempt to disclose *all* compensation in one place.²⁰⁶

tax code and then, new SEC disclosure rules designed to "clear the air" on executive pay).

²⁰² See Lucian Arye Bebchuk, *How Much Does the Boss Make?*, WALL ST. J., Jan. 18, 2006, at A10. Although Bebchuk welcomes the new SEC rules, he notes serious doubts as to their effectiveness in controlling executive compensation. *Id.*

²⁰³ E.g., *The New York City Employees' Retirement System v. Dole Food Co., Inc.*, 969 F.2d 1430, 1432 (2d Cir. 1992) (seeking to use corporate resources to investigate and support certain universal healthcare reforms).

²⁰⁴ See Grundfest, *supra* note 72, at 928.

²⁰⁵ *Id.* Many of the former directors of Enron received cold receptions when they attempted to move on to other Board positions. As a result of shareholder outcry, some of them were removed by the corporation from the ballot. See, e.g., Reed Abelson, *Enron's Many Strands; The Directors: Endgame? Some Enron Board Members Quit or Face Ouster at Other Companies*, N.Y. TIMES, Feb. 9, 2002, at C5.

²⁰⁶ Recent research has indicated that following the new disclosure rules, certain practices were changed. For example, under the new disclosure rules, if executives are granted "in the money" stock options, the proxy statement must include a separate column indicating on what day and at what price the option was struck. Regulation S-K, Item 402(d)(2)(vii), 17 CFR § 229.402(d)-2(vii) (2008). Boards feared embarrassment, especially after the options back-dating scandal and the prospect of *adding* something else to the disclosure. Consequently, many companies have eliminated grants of this type. Other examples include the reduction in certain "stealth" perquisites (use of company jet

This is not to say the new disclosure rules are not without problems. More disclosure could actually cause executive pay to increase, as executives are subject to increased liability.²⁰⁷ It is also improbable that increased proxy disclosure will really help John Q. Public as he makes a decision on where to invest his retirement plan. This would require individual shareholders²⁰⁸ to take the time to read and understand all the disclosure documents, even when written using plain English. This stretches reality.²⁰⁹

Instead, to have the greatest chance at ensuring the right level of compensation is set, not according to politicians but according to the market, the SEC should expand and focus their regulation on tabular disclosure of hard numbers and complete disclosure of total compensation. These are the numbers on which analysts, institutional investors, and hedge funds can base their determination of firm value.²¹⁰ These are the people who actually read

for personal travel, entertainment tickets etc), especially so called tax “gross ups” (where the corporation pays for the additional tax liability incurred as a result of these perquisites). Greg Farrell, *Most Galling of All Perks Could be ‘Gross-ups,’* USA TODAY, Apr. 16, 2007, at B2. This type of perk strikes an especially negative tone amongst shareholders. *Id.*

²⁰⁷ See Loewenstein, *supra* note 8, at 22–24 (“The possibility that increased disclosure increases compensation levels is an example of the potentially unintended effects of regulation. While the SEC is unlikely to reverse itself and lessen the amount of disclosure, it is clear that disclosure should not be regarded as an effective limitation on compensation.”). Another issue which this Note will not address in detail is the effect of disclosure on the information market for total CEO compensation. Although CEOs are advised by compensation consultants as to what the “market-rate” is for their compensation arrangements, having the competing company lay everything out for the public would be invaluable to evaluate one’s own pay packages. This new information could potentially lead to some “underpaid” CEOs demanding increased compensation or face threats of walk outs to the more generous compensating boards; Paolo Cioppa, *Executive Compensation: The Fallacy of Disclosure*, 6 GLOBAL JURIST TOPICS 1207 (2006) (noting that increased disclosure will not necessarily mean decrease compensation).

²⁰⁸ Although institutional shareholders are legitimately concerned with executive compensation, it can hardly be argued that they are in a disadvantaged bargaining position. The outcry over executive compensation comes from those hoping to protect “the little guy” not large institutional investors—they have RiskMetrics. See discussion *supra* at Part III.

²⁰⁹ Interview by Erik Loomis with Thomas W. Joo, Professor, UC Davis School of Law, 3 U.C. DAVIS BUS. L.J. 3 (2002), <http://blj.ucdavis.edu/article.asp?id=512> (Jan. 1, 2003) (“Investors don’t need more financial disclosure. If you ask a group of investors how much of the required disclosures they had actually read, it is likely to be almost none.”).

²¹⁰ Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 14 (2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600709.

and understand the disclosures and their expertise in valuing companies leads to more efficient share value for retail investors.²¹¹ The power of competition and the market will be better equipped to ensure that compensation is appropriate, since inter-company comparisons can more easily be made.²¹² If executives are truly overcompensated based on their talents and available replacements, the free flowing information should allow competition to set the price for executive pay.

The SEC should also substantially reduce the emphasis it seeks to place on the narrative portions of the disclosure requirements, for example, the CD&A.²¹³ To the extent that investors actually look at the disclosures made in proxy statements, they are unlikely to parse through pages of description of process, particularly when, as noted previously, lawyers attempt to make these disclosures as opaque as legally possible.

In this light, the SEC should also revise the rules to eliminate the filing requirement for CD&A and narrative disclosures. As noted previously, the filing requirement would subject boards and executives to liability both under Section 18, 14a-9, and Sarbanes-Oxley for misstatements, without a requirement of scienter. Instead, the SEC should make companies furnish, not file, the disclosures so the civil liability for breach will come under Rule 10b-5, which does require scienter.²¹⁴ Since the CD&A is unlikely to have any substantial effect on compensation levels, exposing companies to liability for misstatements and requiring more efforts in proxy preparation creates large costs with little accompanying benefit. Only intentional or fraudulent acts with respect to CD&A should implicate the full weight of securities liability. Only tabular disclosures which are more important to comparing company compensation practices and can be more definitively crafted should bear that kind of liability.

Due to the recency of the rules, little academic or empirical research has been accomplished that would provide a clearer picture into effect they are likely to have. Further study should focus on the extent to which investors benefit from narrative disclosure as opposed to tabular disclosure. Future

²¹¹ *Id.* at 14–20, 24–29.

²¹² As noted earlier, economics and business academics generally find that the market for executives is competitive and executives are compensated approximately “at market.” See, e.g., *id.*; Loewenstein *supra* note 8, at 22–24; Audio Recording, *supra* note 9.

²¹³ See the Bristol Myers-Squibb case study, discussed *supra* at Part IV.C., where the vast majority of commentary was focused on increased CD&A disclosure as well as decreased legal boilerplate.

²¹⁴ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). It is important to note, however, that the SEC does not need to prove scienter in a Rule 14a action for a misleading proxy statement. 17 C.F.R. § 220.14a-9 (2008). This fact should alleviate concern that by eliminating the filing requirement, boards would receive a pass.

discussions will also have to deal directly with potential judicial interventions into executive compensation and the extent to which disclosure laws affect those proceedings.

VI. CONCLUSIONS

Public skepticism that CEOs and other executives are worth what they are paid is likely overblown by attention-getting headlines of large corporate pay packages which come in the face of decreased shareholder value or market turmoil. One interesting thing to note is that often, the most egregious examples carried by proponents of “fixing” executive compensation happen to be *exit* packages: a sign that corporate governance is working and underperforming CEOs are losing their jobs. Neither Congress nor institutional investors have been there to issue the pink slips. Although it is doubtful whether the crisis in CEO pay is really what it is made out to be, the U.S. corporate system relies on good corporate governance and on informed investors as a balance to even egregious behavior. Information really is the best way to ensure fairness and corporate responsibility. With adjustments, the SEC disclosure rules could focus on what is most important to investors and to corporate governance while foregoing creating costs without overriding benefits.

